Office of Chief Counsel
Internal Revenue Service
memorandum

CC:SB:7:SJ:1:POSTF-106089-02
TDUsitalo

date: APR 0 4 2002

to: Ed Whittinghill, Revenue Agent

from: Trent D. Usitalo, Attorney
Associate Area Counsel (SBSE), San Jose

subject: [redacted] and [redacted], Inc.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

In your memorandum dated January 8, 2002, you asked us to comment on two positions that you proposed taking in connection with the examination of [redacted], Inc.'s (hereinafter "[redacted]") Form 1120 corporate income tax return for the fiscal year ended January 31, [redacted] and the examination of [redacted] and [redacted]'s (hereinafter "the [redacted]") Form 1040 individual income tax return for the taxable year [redacted].

The two positions that you proposed in your memorandum are:

1. Removing the income that was reported on the [redacted]'s Form 1040 from the sale of the franchise agreements and the covenant not to compete and applying that income to [redacted] Form 1120.

2. Reducing the amount of realizable income attributable to the sale of the franchise agreements, as reported by the [redacted], by $[redacted] and increasing the amount of realizable income attributable to the sale of the goodwill, as reported by [redacted], by $[redacted].

In our opinion, both of the positions that you proposed have merit and are articulated well in your memorandum. However, we feel that your second position is

stronger and has a better chance of succeeding in court should litigation become necessary. Therefore, and for the reasons stated below, we recommend that you only advance your second position.

Rather than restating all of the facts that you stated in your memorandum to us, we have attached a copy of the fact section of your memorandum and are incorporating those facts by reference into this memorandum.

Position 1

I.R.C. § 482 states:

> In any case of two or more organizations, trades, or business (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

[redacted] purchased the [redacted] franchises at issue from [redacted] (hereinafter "[redacted]") and the corresponding franchise agreements were issued to him individually. [redacted] attempted to obtain [redacted]'s consent to assign the franchise agreements to [redacted] on numerous occasions, but that consent was never granted because [redacted] failed to execute the proper forms provided by [redacted] that were necessary to effectuate the assignment.

Although the amended Bylaws of [redacted] states that the franchise agreements were assigned to and assumed by [redacted], the assignments were invalid because the terms of the franchise agreements prohibited any assignment without the prior written consent of [redacted]. It is our opinion that [redacted] cannot recognize the income generated from the sale of the franchise agreements because it could not sell

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[1] The amended Bylaws of [redacted] actually states *franchise agreement*, but we assume that it applies to all of the franchise agreements.

something that it did not legally own. We do not think that I.R.C. § 482 allows the government to disregard the legal ownership of the franchise agreements in this particular case because [redacted] (an unrelated third party) had control over whether an assignment of the franchise agreements would be allowed. Thus, [redacted] was not in complete control of the transaction.

We understand that [redacted] sold a franchise (not currently at issue in this case) in [redacted] and reported all of the income from that sale, including the franchise agreement, on its corporate income tax return. With respect to the [redacted] franchise agreements at issue, we further understand that [redacted] continued to conduct its affairs up until the date of the sale as though it owned the franchise agreements by reporting them as an asset on its corporate books and amortizing them on the balance sheets of its corporate income tax returns accordingly. However, we do not feel that the government should perpetuate the incorrect reporting of the income and deductions associated with franchise agreements by removing the income from the [redacted] Form 1040 and applying it to [redacted] Form 1120. We think that it would be more appropriate for the government to adjust the prior and subsequent corporate and individual income tax returns (to the extent that it is able to) to reflect the correct legal ownership of the franchise agreements.

Lastly, regarding the covenant not to compete, we feel that the [redacted] properly reported the income from the covenant not to compete on their individual income tax return because the parties to the agreement were the purchaser and the [redacted] (as shareholders). According to Bemidji Distributing Co. v. Commissioner, T.C. Memo. 2001-260, a covenant not to compete is generally between a purchaser and a shareholder. Thus, the amount resulting from the sale of a business that is allocated to a covenant not to compete will be taxed to the shareholder as ordinary income and will not be taxed at the corporate level. Id.

Position 2

Generally, a franchise encompasses attributes that have traditionally been viewed as goodwill. Canterbury v. Commissioner, 99 T.C. 223, 247 (1992). However, to the extent that these attributes are embodied in the franchise, trademarks and trade name, their cost is amortizable under the provisions of I.R.C. § 1253(d)(2)(A). Id. at 247-248. However, if taxpayers acquire intangible assets, such as goodwill, which are not encompassed by or otherwise attributable to the franchise, then a portion of the purchase price should be allocated to such assets. Id. at 248.

Goodwill is the aggregate value of the relationships and reputation developed by a business with its present and potential customers and associates over a period of time. Larvic Holdings, Inc. v. Commissioner, T.C. Memo. 1998-281. Goodwill has been described as the "expectancy of continued patronage." Id.; Newark Morning Ledger Co. v. United States, 507 U.S. 546, 556 (1993). Goodwill exists where there is an expectancy of both continuing excess earning capacity and of competitive advantage or continued patronage. Wilmot Fleming Engineering Co. v. Commissioner, 65 T.C. 847, 861 (1967). More succinctly, it has been described as the probability that old customers will resort to the old place of business. Metallics Recycling Co. v. Commissioner, 79 T.C. 730 (1982). The indicia of goodwill are numerous and include practically every imaginable trait that has a positive bearing on earnings. Solitron Devices, Inc. v. Commissioner, 80 T.C. 1, 18 (1983), affd. without published opinion 744 F.2d 95 (11th Cir. 1984).

There is frequently an overlap between the goodwill and going-concern value of a business. Id. at 20. Going-concern value has been defined as the additional element of value which attaches to property by reason of its existence as an integral part of a going concern, and that such value is manifested by the ability of the acquired business to continue generating sales without interruption during and after the acquisition. Id. at 19-20; Concord Control, Inc. v. Commissioner, 78 T.C. 742, 746 (1982).

In Canterbury, supra, the taxpayers purchased existing McDonald's restaurant operations, including franchise rights. They sought to allocate the major portion of the purchase prices paid for their existing McDonald's franchises to amortizable franchise expenses, while the government sought to allocate the major portion to 0goodwill (which at the time was not amortizable). The court engaged in an extensive review of McDonald's business practices and found that McDonald's had always charged an original franchise fee well below the market value of such franchises. The court found that the right to use the McDonald's system, trade name and trademarks was the essence of the McDonald's franchise and that the McDonald's franchisees acquired no goodwill separate and apart from the goodwill that was inherent in the McDonald's franchise. The court found that each franchise had a relatively small going concern value, which allowed the franchises to continue to operate without interruption after their acquisition. The court held that after allocation of the proper amounts to the tangible assets purchased and the going concern value of each franchise, the entire purchase price paid for the existing McDonald's franchises was amortizable under I.R.C. § 1253(d0(2)(A).

Although Canterbury is similar to the facts in our case in many respects, we feel that there are some significant differences worth noting. First, in Canterbury, the government failed to provide any kind of quantification methodology to support its

position that the franchise agreements were overvalued. In that case, the court stated, "even if we were inclined to accept respondent's position that there was some goodwill apart from the franchise, respondent has not proposed a value to be attributed to such goodwill and presented no expert testimony on this topic." In our case IRS Engineer John Reilly performed an independent valuation of each one of the assets sold in connection with the sale of the [redacted] franchises at issue.

[redacted] has yet to offer any rebuttal to the findings of the valuation report prepared by Mr. Reilly. In addition, [redacted] admitted that he did not hire an appraiser to value the assets at the time of the sale. Instead, [redacted] and the purchaser agreed on the allocation of the purchase price through the negotiations that took place.

If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate. I.R.C. § 1060(a). Applicable asset acquisition means any direct or indirect transfer of assets which constitute a trade or business, and with respect to which the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets. I.R.C. § 1060(c).

In our case, the government has determined that the allocation of the purchase price made by the taxpayers was not appropriate. The government can go beyond the formal dealings of the parties to see if they reflect meaningful substance. Schulz v. Commissioner, 294 F.2d 52, 56 (1961). One thing that the government should consider is whether different allocations of the purchase price would result in adverse tax consequences for the purchaser. This is important because adverse tax interests deter allocations which lack economic reality. Bemidji Tool & Die Distributing Co. v. Commissioner, T.C. Memo. 2001-260. The court strictly scrutinizes an allocation if it does not have adverse tax consequences for the parties. Id. In our opinion, no adverse tax consequences existed for the purchaser.

When the government challenges a contractual allocation, two tests are applied by the court: (1) whether the contractual allocation has some independent basis in fact or some arguable relationship with business reality such that reasonable persons, genuinely concerned with their economic future, might bargain for such agreement or (2) whether the allocation by the buyer and seller of a lump-sum purchase price is unrealistic, which neither the Commissioner nor the court is bound to accept. Bemidji Distributing Co. v.

Commissioner, T.C. Memo. 2001-260; Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 446-448 (1980).

In his valuation report, Mr. Reilly concluded that the amount of the purchase price allocated to furniture, fixtures and equipment, leasehold improvements, leasehold interest and the covenant not to compete was reasonable. However, Mr. Reilly concluded that the amount allocated to the franchise agreements was overstated by $[redacted] and the amount allocated to goodwill was understated by $[redacted]. In reaching this conclusion, Mr. Reilly determined that the parties to the transaction failed to account for two significant intangible assets when allocating the purchase price -- locational value and capacity capability (both of which are generally classified as goodwill).

In valuing the assets that were sold, Mr. Reilly utilized the income capitalization method, which has been widely accepted by the courts. In Philip Morris, Inc. v. Commissioner, 96 T.C. 606, 624 (1991), the court mentioned that the three most prevalent and useful methods in computing the value of intangible assets are: (1) the bargain method, (2) the residual method, and (3) the capitalization method. However, the court noted that the valuation of intangible assets acquired as part of a going concern is a question of fact that cannot be determined on the basis of any simplistic rule or formula. Id. Each case must be considered on its own merits, and a method chosen based upon the particular facts presented.

The second significant difference between Canterbury and our case is that, in Canterbury, McDonald's owned all of the real estate and buildings that housed the franchised restaurants. As part of the franchise agreement, McDonald's would lease the buildings to the franchisees. [redacted]. As a result, [redacted] had the opportunity to select the exact location for each one of the [redacted] that he developed. Article 4.2.4.(a) of the Target Reservation Agreements required the developer (i.e., [redacted]) to assume all responsibility in locating, acquiring and developing the real estate sites for the construction of the [redacted]. This was to be done at no cost, liability or expense to [redacted]. Thus, site selection, development and construction were divorced from the franchise agreements and needed to be valued independently as locational value.

In addition to locational value, Mr. Reilly determined that capacity capability had intangible value independent of the franchise agreements. In his valuation report, Mr. Reilly noted that the physical layout of the [redacted] varied among the [redacted] franchises at issue. He mentioned that the variety of the layouts should yield different values and

business results, all other things being equal. He concluded that this value cannot be attributed to franchise value because the right to [redacted] and other benefits of the franchise agreements remained the same for the different sized [redacted].

In our opinion, the conclusions reached by Mr. Reilly in his valuation report appear reasonable and we feel that the case law supports reallocating the income accordingly between the franchise agreements and goodwill. Therefore, we recommend that you continue to argue this position.

If you have any questions or wish to discuss this matter further, please contact attorney Trent Usitalo at (408) 817-4668.

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Associate Area Counsel (SBSE)

By: _____
TRENT D. USITALO
Attorney (SBSE)

Attachment